Sharp fall on Wall Street in response to Fed interest rate decision

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In one of the most closely watched decisions for years, the US Federal Reserve Board lifted its base interest rate by 0.25 percentage points yesterday and indicated that it expects the number of rate rises next year to be reduced from three to two.

The decision, the fourth rise this year, puts the Fed's target rate at between 2.25 and 2.50 percent. In a clear indication that it is easing rate rises, the Fed reduced what it considers to be the neutral rate—one that neither stimulates nor dampens the economy—from 3 percent to 2.8 percent.

However, these moves, described as a "dovish" rate hike, were not welcomed by Wall Street. Addicted to the provision of ultra-cheap money in the ten years since the global financial crisis, it fell sharply.

After rising by around 300 points at the start of the day, the Dow fell on the announcement of the rate increase and then dropped even further as Fed chairman Jerome Powell addressed a news conference. It fell by as much as 500 points at one stage, with traders reportedly yelling "Stop this guy talking."

All indexes were down for the day. The Dow fell by 350 points, a drop of 1.5 percent, the S&P 500 index was off by 1.5 percent and the NASDAQ index was down by 2 percent. Following earlier sharp falls, the S&P 500 index has lost 9 percent so far this month. Both the Dow and the S&P have reached their lowest points for the year.

The decision to lift rates was generally expected with many market analysts observing that had the Fed not proceeded this would have sent a downbeat signal on the state of the economy and could have increased, not lessened, market turbulence.

It was preceded by a campaign to bring about a significant shift in the Fed's policy. US president Donald Trump has regularly tweeted that he regards Fed tightening as "crazy" and "loco" and that Fed rate rises were jeopardising US economic growth.

He has now been joined by others. This week the *Wall Street Journal* published a major article by former hedge fund investor Stanley Druckenmiller and a former member of the Fed's governing council, Kevin Warsh, calling for a halt to rate rises.

Their focus was not so much on the US but the state of global financial markets. They pointed to a reversal by global central banks of their 10-year policy of easing liquidity, starting at the beginning of October, noting that stock prices had commenced their fall at that time and "this is no coincidence."

The world's central banks, as part of their quantitative easing (QE) program, had amassed $11 trillion on their balance sheets. Two months ago this gave way to global tightening (QT) as central banks started to run down their balance sheets. While the Fed started this process 15 months ago, it had been offset until now by the asset purchases of other central banks. That situation had now ended.

The article warned that economic growth outside the US had decelerated over the past three months, global trade had slowed markedly, running at one-third lower than a year ago, and growth in important economies, like China, was significantly weaker. "No ocean is large enough to insulate the US economy from slowdowns abroad" and no forecasting model "adequately captures the spillovers and spillbacks from the US economy and the rest of the world."

The two authors directed their principal focus not to the Fed's base interest rate as such, but on the impact of the winding back of the Fed's asset holdings, which stood at more than $4 trillion at their height. They said the Fed's silence on this issue was "contributing to the tumult."

"We were assured by policy makers that QE provided large benefits to the real economy. If so, won't its reversal come with a cost? It can't be all rainbows and unicorns."

They concluded that the Fed could ill afford a major policy error and that it should cease, at least for now, "it's double-barrelled blitz of higher interest rates and tighter liquidity."

After publishing the article, the *Wall Street Journal* weighed in with an editorial emphasising its main points, in particular that the "larger argument for a pause is that the Fed is unwinding the largest experiment in modern history."

"Central banks around the world are moving away from multi-trillion-dollar bond purchases and zero-interest rates, and they're doing it without a road map. What is the 'normal' interest rate in this post-crisis world? We don't know, and we doubt the Fed does either."

Critics of the Fed decision directed attention to Powell's remarks at his press conference that the Fed's reduction of its balance sheet would take place at the rate of $50 billion per month. He indicated this was a pre-set agenda and the focus of the Fed's monetary policy would be on setting the interest rate.

Responding to questions on Trump's interventions, he said the Fed would not be deterred from carrying out its mandate. Insofar as market volatility was concerned, the Fed took this into account through its impact on the tightening of credit conditions which had been in evidence.

Powell said that global growth conditions were not what they were in 2017 when there was "synchronised" global growth and this had been replaced by "modest retracing."

Significantly, the Fed expects growth in the US to to slow. Growth is predicted to be 3 percent in 2018 followed by a fall to 2.3 percent in 2019. Powell said there was an "angst about growth going forward."

On the question of wages, which are always a crucial factor in Fed decisions, Powell said wage rises of around 3 percent were "welcome" and they had not given rise to increased inflation. Wage increases at present were now equivalent to the inflation rate of around 2 percent plus productivity growth of 1 percent. If that situation changes, however, then the Fed can be expected to take a more hawkish approach on rate rises.

Overall, the reaction to the decision points to the underlying fragility of financial markets, which have become a house of cards as a result of the massive inflows of money from the Fed and other central banks, and are now extremely susceptible to even a small tightening in financial conditions.